

GASB #34/35 Issue Paper #2
Recording Internal Service Center Activity

March 15, 2001

ISSUE RESOLUTION

Beginning July 1, 2001 ISC activity will be recorded in COFRS Fund 328 which will be renamed Internal Service Fund.

Beginning July 1, 2001 payments received for ISC activity will be recorded as a credit to COFRS Revenue Source Code 5401 Higher Education Self-Funded Sales & Services.

By 1st quarter FY02 close Higher Education institutions will have moved non-ISC activity currently recorded in Fund 328 to COFRS Fund 326.

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During discussion, the following responses to the options were identified.

Option A requires that internal service fund accounting be performed in a separate fund on COFRS for all internal service center activity. Some institutions have identified computer system problems with separating ISC activity for reporting to a separate fund on COFRS. Higher education is also concerned that reporting as a separate fund to COFRS would result in the requirement, or expectation, that ISC activity would also be presented a separate column on their stand-alone statements. Therefore, the FAC supports reporting using Option B because it supports higher education's intent to combine internal service activity with the business-type activity on their stand-alone statements.

Three ways to achieve Option B were identified and discussed:

- 1) Have the ISC record the payment received from the buyer as a credit to the same expenditure code used by the buyer to record the expense.
- 2) Have the ISC allocate the payment received from the buyer as credits across all the expense codes used by the ISC.
- 3) Have the ISC record the payment received from the buyer as a credit to an expenditure code whose expenditures will naturally be large enough to cover the credits applied when all funds are combined for financial statement reporting.

Consensus could not be reached on any of these three approaches.

Since that discussion, a fourth approach has been suggested by Jud Hurd, UCB:

- 4) Have the ISC record the payment received from the buyer as a credit to a specific expenditure code created for that purpose that would roll up to the Operating and Travel line on the CAFR. Given the unique contra-expense nature of this specific expenditure code, it would not create an abnormal balance distortion during the fiscal year. Given that the vast majority of expenditure codes used by the buyers will also roll up to the Operating and Travel line on the CAFR, the elimination of expenditures and revenue required for financial reporting purposes would be accomplished.

Several questions remain to be answered regarding approach 4:

- In past discussion, SCO staff indicated a need to eliminate revenues against the expenditures recorded by the buying agencies and to eliminate revenues against the expenditures of the ISC. Which is the required elimination? If the later, could the requirement be for a year-end allocation of the credits in the specific expenditure code proposed by approach 4 to all the expenditures codes used by the ISC?
- In past discussion, some desire was expressed by higher education to have the ISC activity broken out of COFRS fund 328 where it is currently reported and coded to a unique ISC fund which would be used for management reporting only and not for reporting as a separate fund/column on the CAFR or the stand-alone financial statements. Does approach 4 negate that desire? If not, there is another set of questions:
 - Do institutions other than CU currently report both ISC and non-ISC non-Balance Sheet activity in the COFRS 328 fund? If so, what is the nature of the non-ISC activity?
 - Would institutions other than CU have problems in segregating ISC and non-ISC activity currently in the COFRS 328 fund for feeding to separate funds on COFRS?
- If implemented, would approach 4 create a problem for the stand-alone statements that will report using the natural classifications or for the reconciliation between natural and object classifications?
- To what program code are institutions currently charging ISC activity? Is it necessary, or would it be beneficial, for all institutions to use the same COFRS program code?
- If approach 4 were implemented, would it be necessary for all institutions to use the same COFRS program code on both the buyer and seller side of the transactions?
- Is there guidance in the #35 Implementation Guide? Does it change the current industry standard that requires crediting expenditures rather than recording revenues for payments received by an ISC?

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GASB #34/35 requires that the effect of internal service center (ISC) activity reported separately as Internal Service Funds be eliminated. A pro rata reduction in the charges made to the participating funds/functions for internal service fund net income must be made. Conversely, a pro rata increase in the amounts charged to the participating funds/functions for an internal service fund net loss must be made. (GASB#34, ¶314) This is **option A** and would require internal service fund accounting in a separate fund on COFRS for all internal service center activity. On the Government-wide Statement of Activities, the higher education BTA will be combined into a single column with the other state BTA entities. On the Fund Statement of Revenues, Expenses, and Changes in Fund Balances, higher education will be reported alone in a single column as a proprietary fund. In both cases, if higher education were to report its ISC separately as an Internal Service Fund per **option A**, that activity would appear as a separate column.

However, the ISC activity of an entity reporting as a Business Type Activity (BTA) need not be reported separately as Internal Service Fund activity but may be combined with all other higher education activity. When that is the case, the ISC activity need not be eliminated in the manner required above. This is **option B** and would allow the current higher education practice of crediting expenditures rather than recording revenues for payments received to continue with some changes.

If **option B** were exercised, an abnormal balance resulting from crediting payments in an account in excess of the expenditures recorded in the same account would be problematic for SCO. The suggested solution would be for payments to be allocated across all expenditures codes used by the ISC or applied to a single expenditure account that would be offset to the same expenditure account when all activity of the BTA is combined. Specifically, assume the College of Business (COB) purchases printing services from both an ISC and an outside vendor. The COB records printing expense in both cases. If the ISC records the payments it receives from the COB as a reduction of an operating expenditure that is less than the payment received, an abnormal balance would result. If the total debits to that operating expenditure code across all of the BTA were not larger than the credit recorded by the ISC, there would be an abnormal balance at the financial statement reporting level. Therefore, the SCO suggests that the payment be **1)** credited to printing expense to offset the printing expense debit recorded by the COB or **2)** allocated across all the expense codes debited by the ISC.

Since the State will be reporting using natural classifications, in the CAFR **approach 1)** would result in an understatement of the entity's printing expenses while **approach 2)** would result in an understatement of the entity's personnel and operating expenses. Since the higher education stand-alone statements will be reported using functional classifications, **approach 1)** would result in an understatement of Instructional expenses since that is the functional area where the COB is reported while **approach 2)** would result in an understatement of Auxiliary Enterprises expenses since that is the functional area where the ISC is reported.

It is the desire of the higher education institutions to continue its current practice of crediting expenditures rather than recording revenues for payments received per **option B**. This is not internal service fund accounting so this approach would require that ISC activity be combined with all other BTA activity on its stand-alone statements and on the CAFR. Therefore, higher education suggests as **approach 3)** that ISC activity be recorded in a separate fund on COFRS and that the payment be credited to the Auxiliary Enterprises program code and to an object code whose expenditures will naturally be large enough to cover the credits applied when all funds are combined for financial statement reporting. Doing this ISC accounting in a separate fund would allow that fund to be excluded from management reporting thus allowing accurate reporting of the true expenditures and revenues of all the entity's operating units.

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- Decision Points
 - Which option, **A or B**, will higher education use to record ISC activity?
 - If **option B is used**, will **approach 1), 2) or 3)** be used to determine the object code to which payments will be credited for CAFR reporting purposes?
 - If **option B is used**, will **approach 1), 2) or 3)** be used to determine the program code to which payments will be credited for purposes of higher education's stand-alone statements?

- Additional questions:
 - How should sales to external customers by an ISC be recorded?
 - What is an external customer for the stand-alone statements? For the CAFR?
 - What, if any, changes must be made to current practice as displayed below?
 - Is a change to the Accounting Standards necessary?
 - Is a change to the TABOR Guidelines necessary?

- Current Practice:
 - If the unit is an enterprise, record sales in fund 320/NAP as a credit to expenditures.
 - If the unit is not an enterprise, record sales to internal customers in fund 328/NAP as a credit to expenditures and record sales to external customers in fund 329/LBA as revenue.
 - Internal is defined as the State of Colorado and therefore includes other state agencies and institutions.